INDEX

CITATIONS

Cases:

In the Supreme Court of the United States

OCTOBER TERM, 1938

No. 328

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. J. REYNOLDS TOBACCO COMPANY

ON WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE FOURTH CIRCUIT

BRIEF FOR THE PETITIONER

OPINIONS BELOW

The opinion of the Board of Tax Appeals (R. 14–28) is reported in 35 B. T. A. 949. The opinion of the Circuit Court of Appeals (R. 70–78) is reported in 97 F. (2d) 302.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on June 6, 1938. (R. 78.) The petition for certiorari was filed on September 6, 1938, and granted on October 17, 1938. (R. 78.) The

jurisdiction of this Court rests on Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTIONS PRESENTED

Respondent during 1929 sold through brokers on the New York Stock Exchange 209,000 shares of its own common stock, part of which it had purchased in 1921 and part in 1929. The aggregate amount of cash received by respondent on the sales exceeded the cost of the shares to it by $286,531.21.

1. Does the gain thus derived by respondent from dealings in its own stock come within the definition of gross income in Section 22 (a) of the Revenue Act of 1928?

2. Must Article 66 of Treasury Regulations 74, as amended in 1934, which treats such gain as income, be denied application?

STATUTE AND OTHER AUTHORITIES INVOLVED

The statute and other authorities involved will be found in the Appendix, *infra,* pp. 51–54.

STATEMENT

The facts were found by the Board of Tax Appeals on the basis of a stipulation (R. 43–49), testimony of the chairman of the Board of Directors of the taxpayer (R. 50–61), and certain documentary exhibits (R. 62–67).

The taxpayer is a corporation organized in 1899 under the laws of New Jersey, having its principal office and place of business in Winston-Salem,

North Carolina, and engaged in the manufacture and sale of tobacco products (R. 15). The present controversy involves the year 1929. During that year respondent sold through brokers, on the New York Stock Exchange, a total of 209,000 shares of its own so-called new class B common stock (R. 18). One block of 15,000 shares had been acquired in 1921 at a cost to respondent of $121,440.19 in cash. This block was sold for cash in the amount of $708,690. Another block representing 94,500 shares had been purchased in the latter part of 1929 for cash in the amount of $4,908,966.17. These were sold for cash in the amount of $4,506,497. A third block of 99,500 shares had also been acquired in the latter part of 1929 for cash in the amount of $4,601,807.43 (R. 18–19). These were sold for cash in the amount of $4,703,608 (*Ibid.*). The stock certificates covering the shares thus sold in 1929 were endorsed, surrendered, cancelled and reissued in the same normal manner as sales and purchases of all of respondent's shares of stock. (R. 19.) The difference between the cost and the selling price of the shares thus sold, $286,581.21, was reflected on respondent's books as a cash item; was placed in respondent's surplus account; and was included in the financial statement of the company made to its stockholders. (R. 19–20.) On respondent's income tax return for 1929 this amount was listed as "profit RJR stock" under the caption "Other Items of Nontaxable Income". (Ex. D, p. 3, following R. 48; cf. R. 17–18, 20–21.)

Other shares of its own stock which respondent had acquired in 1921 and in 1929 but which were not disposed of in 1929 were carried on the company's books as "Investments in Non-competitive Companies." (R. 19.) Of the amount of $19,601,594.77 appearing on respondent's books in this account, $19,270,690.98 represented such shares, 431,925 in number (*ibid.*). At no time did respondent's books show any increase or reduction in its capital stock on account of these transactions. (R. 19.)

By amended answer to respondent's petition in the Board of Tax Appeals (relating to other questions), the Commissioner asserted that respondent's net income should be increased by the amount of the "net profit realized by the R. J. Reynolds Tobacco Company through trafficking in Class B common stock of the R. J. Reynolds Tobacco Company." (R. 9.) Claim for deficiency was accordingly made (*ibid.*).

The Board included in its findings a detailed statement of the background and circumstances of the sales of stock in 1929 which are the subject of the present controversy. These may be stated as follows, giving first the events prior to 1929 and next the events in that year:

Events prior to 1929.—From time to time since 1901 the capital structure of the corporation has been changed by increases in the common stock by the issuance of new classes of common stock known

7

as class B common, later eliminated in favor of new class B common; by the issuance and subsequent retirement of preferred stock; by stock dividends; and by stock split-ups due to reduction in the par value of the common stock. (R. 15.) During the taxable year 1929 the total capitalization of R. J. Reynolds Tobacco Company was (R. 15):

1,000,000 shares common stock at $10 par value	$10,000,000
9,000,000 shares new class B common stock at $10 par value	90,000,000
10,000,000 shares outstanding capital stock	$100,000,000

The principal difference between common stock and new class B common is that the latter had no voting power and was not considered under the company's plan providing for participation by officers and employees in certain profits of the company. There was no authorization during the taxable year by charter amendment whereby the authorized number, class, or par value of taxpayer's shares of stock was increased or decreased. (R. 15.)

In 1912 the taxpayer was young in the tobacco industry, being a very small corporation whose stock was owned by one family until other stockholders were brought in from time to time. Its principal stockholder and founder was R. J. Reynolds, whose practice it was to bring as many employees as possible into the company as stockholders. Under the by-laws of the company the holders of the only stock then outstanding were entitled to a special distribution each year based on

the profits realized, and as a result the owners of this class of stock retained their holdings in order to participate in the profits. (R. 15.)

At 1912 taxpayer was in vigorous competition with three other tobacco companies, each having many times the capital of taxpayer. After 1912 taxpayer's growth was rapid. Its business prospered to such an extent that maintaining the capitalization of the company at a point where it could support the rapid expansion of the business, and meet competitive conditions, presented a serious problem. At the same time the management of the taxpayer desired to preserve (1) the reputation of the company, (2) the reputation of the stock, and (3) the behavior of the stock on the market, including its behavior in comparison with other similar stocks. (R. 15.)

In 1918 the taxpayer created the class B common stock which did not participate in the special distribution based on the company's profits, and which was, therefore, available on the open market. Later this class B stock was eliminated by charter amendment in April 1926. (R. 15–16.)

In July 1918 R. J. Reynolds, taxpayer's largest stockholder, died. It became necessary for his estate to sell a substantial portion of the stock in order to pay the inheritance taxes on his estate. This stock was purchased by several individuals, but subsequently and prior to 1921 it was finally concentrated in the single ownership of United Retail Stores, which controlled United Cigar Stores

a large distributor of taxpayer's tobacco products. United Retail Stores publicized the fact that it owned a substantial block of taxpayer's stock. Rumors developed and the suspicion grew that United Retail Stores was dictating taxpayer's business policies and was able to buy taxpayer's tobacco products at lower prices and for better discount than other distributors and retailers. Furthermore, the dividends regularly paid by the taxpayer made it possible for United Retail Stores to operate its approximately 2,000 retail stores without profit, and yet have a substantial amount with which to pay dividends to its own stockholders. (R. 16.)

It was the judgment of taxpayer's management that the reputation of the company and the necessity of protecting its business required the purchase of this United Retail Stores stock. Taxpayer had recognized in 1918 the necessity of broadening its stockholding base, and the acquisition of this block of stock afforded taxpayer an opportunity to remove a harmful situation and at the same time permitted taxpayer to expand its stockholding list by feeding the stock back onto the market. The law department of the taxpayer considered and ruled that taxpayer was authorized to make the 1921 purchase, and the other purchases hereinafter related, and reissue the stock, although taxpayer had no charter authority to deal in its own stocks. (R. 16.)

For the reasons aforementioned the taxpayer purchased during 1921 the block of old class B common stock held by United Retail Stores, the number of shares purchased being undisclosed. The purchase was made at a private sale, the stock in question not being listed on any exchange in 1921. The consideration paid was $607,200.96 in cash, which was slightly under the market price by reason of the amount of stock involved. As a result of subsequently effected stock split-ups and stock dividends that portion of this purchase here involved came to represent 75,000 shares of new class B common stock, the certificates therefor being held by taxpayer on January 31, 1929. (R. 16.)

During all the years 1921 to 1929, inclusive, and thereafter, the taxpayer followed the same general policy of availing itself of all opportunities that were presented for extending its stockholding base. The effectiveness of this general policy is revealed by the increase in the number of taxpayer's stockholders over a period of years. In March, 1922, when taxpayer's stock was listed on the New York Stock Exchange, taxpayer had less than 2,000 stockholders, counting common stock and class B common stock. At the time of the market crash in 1929 there were 9,136 shareholders of B stock alone. In 1933 there were 41,000 stockholders and in April, 1936, there were 52,000 holders of B stock. (R. 16–17.)

In 1924 taxpayer sold for cash 21,067 shares of the stock purchased in 1921 from United Retail Stores. The sales were made in the second and third quarters of 1924 on a rising market, following a substantial drop of the market in the first quarter. (R. 17.)

In 1925 the taxpayer sold for cash 11,000 shares of the stock purchased in 1921 from United Retail Stores. These shares were sold or reissued between February 10 and August 13, 1925. The management took advantage of a rising market to dispose of these shares without hurting its stock or the reputation of the taxpayer. (R. 17.)

By reason of a charter amendment in 1926 the management of taxpayer feared that speculators on the market might start a rumor that taxpayer would declare a stock dividend. To protect the reputation of the stock, which included keeping it from jumping and precipitately dropping, the taxpayer purchased through a broker for cash 21,400 shares of its stock. After fear of the rumor had passed the 21,400 shares were gradually fed back into the market. (R. 17.)

In 1927 the taxpayer's only transaction respecting its own stocks was the disposition of certain fractional shares accumulated in its hands in connection with the issuance of rights to subscribe or receive additional stock. These fractional shares, which had cost taxpayer nothing, were disposed of for cash in the amount of $240.83. (R. 17.)

During April 1928, taxpayer reduced the price of its cigarettes from $6.40 to $6 per thousand. Following this reduction the volume of taxpayer's stock offered on the market was greatly multiplied. Taxpayer, with a view to protecting the reputation of the stock of the company, its business, and its brands, purchased for cash 43,300 shares of its stock, expecting thereby to protect the market against a precipitate fall in prices. After the market steadied the 43,300 shares were fed back into the market, together with 1,240 shares of the stock acquired from United Retail Stores in 1921. (R. 17.)

During each of the aforesaid years 1924 to 1928, inclusive, the taxpayer, R. J. Reynolds Tobacco Company, reissued solely for cash certain shares of its new class B common stock, theretofore acquired solely for cash, in a manner similar to that hereinafter set forth with respect to the taxable year 1929. Such transactions were made under circumstances and for reasons substantially similar to those surrounding the said similar transactions in the year 1929. For the purpose only of showing generally the result of such transactions during each of said years 1924 to 1928, inclusive, and for no other purpose, the parties below agreed that, in executing its income tax return for each of such prior years, the taxpayer noted in "Schedule L—Reconciliation of Net Income and Analysis of Change in Surplus" and under subtitle (of

said Schedule L) entitled "2. Non-taxable income * * * (f) Other Items of Non-Taxable Income (to be detailed)" under the notation "Profit R. J. R. Stock," or substantially similar notation, the following amounts (R. 17–18):

Years:	Amounts
1924	$999, 335. 25
1925	601, 507. 42
1926	85, 003. 70
1927	240. 83
1928	1, 271, 023. 19

At the close of 1928 taxpayer had 30,000 shares of its new class B common stock, which became 75,000 shares by January 31, 1929, due to a $2\frac{1}{2}$ for 1 split-up approved by the stockholders on December 28, 1928, thus reducing the par value of the stock from $25 per share to $10 per share. (R. 18.)

Events during 1929.—Subsequent to January 31, 1929, the taxpayer canceled certificates representing 15,000 shares of said 75,000 shares acquired in 1921 and issued in lieu thereof new certificates representing 15.000 shares of new class B common stock to divers persons who delivered to taxpayer the sum of $708,690 in cash for said 15,000 shares. The 15,000 shares so disposed of by taxpayer were acquired as a part of taxpayer's 1921 purchase at a cost to taxpayer of $121,440.19 in cash. (R. 18.)

On December 18, 1929, 2,106,139 shares, or more than 23 percent of the total outstanding 9,000,000 shares of taxpayer's new class B common stock, were in the hands of brokers, subject to trading or speculation. This stock was in a position to do

great injury to taxpayer, its stock, and its products. Approximately 2,000 employees of taxpayer held shares of its stock and many of them had borrowed heavily on their stock. With the then market price of approximately 64, a heavy drop in the market would have been disastrous to many of taxpayer's employees. (R. 18.)

At the time of the market break in 1929 taxpayer had $29,000,000 in cash and Government securities, which the management determined to and did use in purchasing the taxpayer's stock offered on the market during the break in October and November 1929. During the height of the stock market panic, from approximately October 29 to November 13, 1929, taxpayer held the market price of its stock at 50, purchasing 90 per cent of its stock offered on the market. As the panic eased, taxpayer's purchases were scaled down to 40 and 39. During the taxable year 1929 taxpayer purchased a total of 574,880 shares of its own stock. (R. 18.)

In addition to selling the 15,000 shares aforementioned during 1929, taxpayer sold 194,000 other shares of the new class B common stock it had purchased in 1929. One block representing 94,500 shares of new class B common stock was acquired by taxpayer for cash in the amount of $4,908,966.17. Later in 1929 taxpayer canceled the certificates representing these 94,500 shares, issuing new class B common stock certificates in lieu thereof to divers persons for $4,506,497 in cash. Another block of 99,500 shares of new class B common stock

was acquired by taxpayer in 1929 for $4,601,807.43 in cash. Later in 1929 taxpayer canceled the certificates representing these 99,500 shares, issuing new class B common stock certificates in lieu thereof to divers persons for $4,703,608 in cash. The transactions covering the said 94,500 and 99,500 share blocks of stock were handled by brokers on the New York Stock Exchange. (R. 18–19.)

At all times during 1929 the stock books and records of the taxpayer indicated that the number of its new class B common stock issued and outstanding was 9,000,000 shares. From the time of acquisition of the certificates representing shares of taxpayer's stock until the time of their cancellation and the issuance of new certificates in lieu thereof, the said certificates were regularly entered and recorded on the balance sheets in the financial statement of taxpayer under the entry "Investments in Non-competitive Companies," in which all of such stock was entered and carried at the amount of cash for which it was acquired. The said transactions in respect thereof were not entered or recorded in any records of taxpayer as either increasing or reducing the number of the outstanding shares of its capital stock. At the times of the acquisitions by taxpayer of certificates representing its capital stock, as set forth hereinabove, the cash of taxpayer was reduced by the amounts of cash expended for their acquisition. Likewise, at the

times in 1929 when the said certificates were disposed of, the cash of taxpayer was increased by the amounts received from the disposition thereof. (R. 19.)

At the close of the taxable year the taxpayer had on hand 431,925 shares of its new class B common stock. As of December 31, 1929, these shares represented $19,270,690.98 out of the $19,601,594.77 total appearing on taxpayer's books in the amount designated "Investments in Non-competitive Companies." The balance of the account represented investments in the stock of two small licorice companies (from which taxpayer secured its supplies of licorice), and stock in the Glenn Tobacco Company. None of the shares of stock of the last mentioned three companies was for sale or was traded in by taxpayer. (R. 19.)

The profit from the sale by taxpayer of its own shares of stock arose solely through the sale of new class B common stock. The stock certificates covering the shares sold in 1929 were endorsed, surrendered, canceled, and reissued in the same normal manner as sales and purchases of all of taxpayer's shares of stock. Each transaction involved herein was a completed and closed transaction in the taxable year 1929. During 1929 each and every acquisition and each and every sale made by taxpayer of its own stock was for cash and in no instance for anything except cash. (R. 19.)

Taxpayer's 1929 income tax return, Schedule L, indicates a nontaxable profit of $436,581.21. It was stipulated that the last mentioned figure should

be reduced by a $150,000 dividend to $286,581.21. The $436,581.21 item is reflected in taxpayer's books as a cash item. The item went into taxpayer's surplus account and was included in the financial statement of the company made to its stockholders. It was carried as a nontaxable item in accordance with taxpayer's understanding of what it was and because of Treasury Department regulations. (R. 19–20.)

In his examination and audit for the year 1929, the Commissioner did not, prior to his pleading in the Board of Tax Appeals on the taxpayer's petition to review a deficiency originally asserted on other grounds, include as taxable income or deductible loss any amount arising out of, or resulting from, the transactions hereinabove recited. (R. 20.)

The parties made a stipulation with respect to the deficiency originally asserted. (R. 20.)

The Board of Tax Appeals ruled that taxpayer's gains from dealings in its own stock were taxable under the amended regulation, T. D. 4430, which it held valid. (R. 20.) The Circuit Court of Appeals held that the Treasury Regulations in effect during 1929 were consistent with Section 22 (a) of the Revenue Act of 1928, that they had received legislative sanction through the continued reenactment of the statutory provision and were therefore controlling. It held that the gain from dealing in the taxpayer's own stock during the taxable year was not subject to tax, and reversed the decision of the Board of Tax Appeals. (R. 70–78.)

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the gain derived by the taxpayer from dealing in its own stock under the circumstances of this case was not subject to the Federal income tax.

2. In failing to hold that the gain derived by the taxpayer from dealing in its own stock under the circumstances of this case was taxable income under Section 22 (a) of the Revenue Act of 1928 and under the Sixteenth Amendment.

3. In holding that Article 66 of Treasury Regulations 74, prior to its amendment by T. D. 4430, was consistent with Section 22 (a) of the Revenue Act of 1928.

4. In failing to hold that Article 66 of Treasury Regulations 74, prior to its amendment by T. D. 4430, was in conflict with Section 22 (a) of the Revenue Act of 1928 and was therefore invalid.

5. In holding that T. D. 4430, amending Article 66 of Treasury Regulations 74, could not properly be applied retroactively.

6. In failing to hold that Article 66 of Treasury Regulations 74, as amended by T. D. 4430, was valid, and applicable to the facts of this case.

7. In reversing the decision of the Board of Tax Appeals.

SUMMARY OF ARGUMENT

I

The gain derived by respondent from its dealings in its own stock is gross income under Section 22

(a) of the Revenue Act of 1928. The broad range of the statutory definition of gross income has been repeatedly emphasized by this Court. The definition is intended to embrace whatever is commonly understood as income, and it is essentially coextensive with the scope of Congressional power under the Constitution. Here the corporation realized a gain in cash, in the amount of the excess of receipts from the sale of its stock over their cost to the corporation, without any attendant change in the number or nature of its shareholding accounts. This is a typical case of realized corporate gain as commonly understood.

It avails nothing to label a realized gain in cash an accretion to capital. This is shown by the cases holding that taxable income is derived from the conversion of capital assets, and from bond premiums. *Merchants Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552. The distinction between what was done here and the actual retirement and reduction of capital stock with the issuance of new capital, is a difference having important legal and practical features.

A number of courts have held that a corporation's own stock taken in exchange for property or in settlement of a debt to the corporation is itself property under the Revenue Acts.

The treatment by accountants of treasury stock and gains on its sale is a subject of wide difference of opinion. In any event, such accounting practice or theory would not be determinative. Re-

spondent treated the treasury stock as assets and the gain on its sale as income, though nontaxable. Suggestions that such gain should be credited to a capital surplus account are founded chiefly on considerations of business judgment, particularly in view of the dangers inherent in the power of a corporation to deal in its own shares.

II

Article 66 of Regulations 74, under the Revenue Act of 1928, as the article was amended in 1934, clearly treats the gain in the present case as income. Congress has given express authority in the Revenue Acts to make amended regulations thus effective. Whether amended regulations shall have prospective effect only is a matter confided by the statute to the discretion of the Commissioner and the Secretary.

The fact that the definition of gross income was reenacted without change while earlier and different regulations were in effect should not prevent the application of the amended regulation. The amended regulation has itself been followed by two Congressional reenactments. If the doctrine of reenactment is to be applied, it is thus necessary to choose between implied approval of the earlier regulations and implied approval of the amended regulations. In such a situation the express authority conferred on the Commissioner to amend the regulations should be controlling.

The cases in which this Court has applied the rule of reenactment were not concerned with subsequent amendment. Where that question has been presented, the amended regulations have been given effect. *Morrissey* v. *Commissioner*, 296 U. S. 344; *Murphy Oil Co.* v. *Burnet*, 287 U. S. 299.

The rule of reenactment can have litt[illegible] bearing here, where the regulations purport to interpret general statutory language which is in substance coextensive with constitutional power. Cf. *Helvering* v. *Powers*, 293 U. S. 214, 224. There is no good reason why the Commissioner, in performing the function of interpretation, may not reexamine and reformulate his interpretations much as do the courts. Cf. *Manhattan Co.* v. *Commissioner*, 297 U. S. 129, 135. The exercise of this power in the present situation was particularly appropriate, in view of decisions of the courts indicating that the then existing regulations were untenable or unclear. And the Commissioner's position looks to the recognition of losses as well as gains.

In amending the regulations the Commissioner has properly left to Congress the question whether disproportionate hardship will result to certain classes of taxpayers entitling them to remedial legislation; and has necessarily left to the courts the question whether the amended regulations are a sound interpretation of the statutory and constitutional concept of income.

ARGUMENT

I

THE GAIN DERIVED BY RESPONDENT FROM DEALINGS IN ITS OWN STOCK IS GROSS INCOME UNDER SECTION 22 (a) OF THE REVENUE ACT OF 1928

By virtue of sales of its stock on the market in 1929 at an aggregate price exceeding the price which it had paid for the shares, the respondent realized a cash increment in that year in the amount of $286,581.21. The question in this case is whether that cash increment may be included in respondent's gross income. This question may conveniently be discussed under two aspects: (1) whether the amount is gross income within the scope of the Revenue Act of 1928; and (2) whether the regulations in their present form, which are applicable in terms and which require the inclusion of this amount in gross income, must be denied application because of the existence of earlier and different regulations.

In considering the first of these two points, it is important that the scope of the statutory definition of gross income be kept clearly in view. Section 22 (a) of the Revenue Act of 1928, which is the same in substance as the corresponding section in prior and subsequent Acts, defines gross income as follows:

> *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in

> whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

The broad sweep of this provision has been recognized repeatedly by this Court. In its definition of income ' Congress intended to use its power to the full extent." *Irwin* v. *Gavit,* 268 U. S. 161, 166; *Douglas* v. *Willcuts,* 296 U. S. 1, 9. Or, as it has also been said, Congress has revealed an intention "to reach pretty much every sort of income subject to the federal power." *United States* v. *Safety Car Heating Co.,* 297 U. S. 88, 93; *Helvering* v. *Stockholms Enskilda Bank,* 293 U. S. 84, 89.

In applying the definition of income it must be kept in view also that the term was used not in any special or technical sense; it is to be given "the commonly understood meaning of the term which must have been in the minds of the people when they adopted the Sixteenth Amendment to the Constitution." *Merchants Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509, 519. Thus in dealing with the term "gross income" there is especial reason for applying the rule that the words of a Revenue Act are presumed to be used in their ordinary and usual sense, and with the meaning commonly

114177—38——4

attributable to them. Cf. *De Ganay* v. *Lederer*, 250 U. S. 376, 381.

In the light of the principles that Congress has intended to reach gross income to the full extent of its constitutional power, and that the concept is to be given its ordinarily understood meaning, we may examine the salient facts of the transactions in question. The stock which the respondent purchased and wished to sell was held in the name of a nominee. The respondent granted an option on some of the stock to certain parties at a stated price for the purchase of shares, and the optionees proceeded to make such disposition of the shares as they could and called for delivery. Upon confirmation, the stock was endorsed in blank by the taxpayer's nominee and delivered to the optionee. The stock books of respondent did not show any different treatment of these certificates than of any other certificates. Those shares which the respondent had purchased for resale but which in fact were not sold during the taxable year were carried on its books as "investments in non-competitive companies". Of the amount of $19,601,594.77 shown in that account, $19,270,690.98 represented respondent's own stock of the class here involved. Not only did respondent carry this stock on its books as an investment, but it paid dividends to itself on this stock as dividends were declared. The books and records of respondent indicated no change in the number of its outstanding shares,

either as a result of the acquisition of its shares or of their resale. At the time of the acquisition of the shares the respondent's cash was reduced by the amount expended; and when the shares were disposed of by respondent, its cash was increased by the amounts received. It is the increment in the cash account of respondent which is here sought to be taxed.

It seems to us plain that what was said in *Irwin* v. *Gavit,* 268 U. S. 161, 166, is equally pertinent here: "If these payments properly may be called income by the common understanding of that word and the statute has failed to hit them it has missed so much of the general purpose that it expresses at the start." It will be observed that there is no question in the present case of the *realization* or *receipt* of income; the amount involved was cash paid into the hands of respondent in the taxable year. If the amount by which the taxpayer's cash account was enriched is not to be regarded as income, the scope of that concept will fail to accord with ordinary understanding.

No court has undertaken to hold that the enrichment thus realized by a corporation's dealing in its own shares is not within the constitutional ambit of the income tax. The court below was careful to declare only that in its opinion differing views of the statute were permissible. The Circuit Court of Appeals for the Third Circuit in *First Chrold Corporation* v. *Commission,* 97 F. (2d) 22, pend-

ing on certiorari, No. 385, held the gain taxable. The Circuit Court of Appeals for the Second Circuit in *E. R. Squibb & Sons* v. *Helvering*, 98 F. (2d) 69, expressly refrained from intimating that such gain could not be taxed by Congress as income under the Sixteenth Amendment (p. 70). This view of the decisions is apparently shared by respondent (Brief in Opposition, 15–18). In view of the recognition by this Court, as noted above, of the coextensive scope of the Sixteenth Amendment and the statutory definition of gross income, it would be difficult to rule out this gain from the definition of gross income on any other than constitutional grounds; and no such grounds have been taken.

The principal consideration urged against treating the gain as income is that it is in the nature of the proceeds derived from the original issuance of shares. It is agreed that in the latter situation the amount received by the corporation is not income. But the analogy is a fallacious one. The original issuance of shares results in the creation of corporate capital. The cash or property received by the corporation is offset by the creation of a corresponding liability to shareholders. But where a corporation acquires its own shares and sells them on the market without a retirement or reduction of its capital stock, the situation is fundamentally different. In such a situation, viewing the position of the corporation immediately before the purchase and immediately after the sale, the cash assets

of the corporation have been augmented (or diminished) without any change in the claims of shareholders against the corporation. The amount by which the assets have been thus augmented is clearly gain, and gain to the corporation itself. It is submitted that the analysis in the *Squibb* case, *supra,* is faulty for the reason that the court there compared the position of the corporation before and after the sale of its treasury shares, instead of comparing its position before the acquisition of the shares and after their sale. It is the dealing in the shares—their acquisition and sale, without retirement—which gives rise to income.

An additional word should be said about the supposed analogy to the retirement of shares and the issuance of new shares. The difference between what was done in the present case and what would have been done in the case of retirement is more than a difference in form. Important legal and practical distinctions are involved. The purchase by a corporation of its shares without retirement enables it to sell them without observing the preemptive right of shareholders; to sell them without conformity to the legal requirements as to the price which must be received; to sell them without conformity to statutory or charter requirements that a reduction in capital stock be effected by a vote of the board of directors and of stockholders and the filing of public notice thereof. A corporation which is enabled to secure these advantages by refraining

from retiring the stock cannot urge, it is submitted, that what it did was tantamount to retirement and reduction of capital.

Furthermore, the distinction between the holding of treasury shares and the retirement of stock is carefully observed in the taxing law of respondent's state of incorporation. New Jersey imposes a franchise tax measured by capital stock "issued and outstanding." It is there held that the tax is properly imposed on treasury shares. *Knickerbocker Importation Co.* v. *Board of Assessors,* 74 N. J. L. 583. In that case the New Jersey court distinguished sharply between a true reduction in capital stock, which must be effected in accordance with the statutory procedure, and an acquisition of stock held by the corporation as treasury shares. "Stock once issued", the court said (p. 590), "is and remains outstanding until retired and canceled by the method provided by statute for the retirement and cancellation of capital stock; * * *." (Per Dill, J.)

It is argued that corporate stock held as treasury shares cannot be regarded as assets or property of the corporation, and that hence gain derived from its disposition is not income derived from "dealings in property" within the statutory definition of gross income. This argument ignores the fact that the definition of gross income is not thus limited. It extends to "gains or profits and income derived from any source whatever." Furthermore, it cannot be said that treasury shares are not prop-

erty from the standpoint of the corporation. If a corporation acquires or deals in its own shares as it might in the shares of another corporation, its own shares constitute property within the meaning of the Revenue Act. This principle has been established in a number of cases which merit discussion here because of their effect in leading to a re-examination and reformulation of the regulations concerning dealings by a corporation in its own shares. These decisions involved the question of gain or loss on the sale or exchange of property for cash or other property.

The first of these decisions is *Walville Lumber Co.* v. *Commissioner*, 35 F. (2d) 445 (C. C. A. 9th, 1929), in which the taxpayer claimed a loss upon the dissolution of a corporation in which it owned a majority of the stock, and which in turn owned a majority of the taxpayer's stock. The Government contended that the transaction amounted to a purchase by the taxpayer corporation of its own stock which could not result in gain or loss under the Treasury Regulations. This argument apparently was based on Article 542 of Treasury Regulations 45, relating to the Revenue Act of 1918, which provided that a corporation realizes no gain or loss from the purchase of its own stock and which corresponds to Article 66 of Treasury Regulations 74, *infra*, p. 51, prior to its amendment by Treasury Decision 4430, *infra*, p. 52. The court rejected the Government's contention that this was a capital

transaction, and treated the taxpayer's own stock like any other property. The decision of the Board of Tax Appeals was reversed.

The *Walville Lumber Co.* case was followed by a decision of the First Circuit in *Commissioner* v. *S. A. Woods Mach. Co.*, 57 F. (2d) 635 (1932), certiorari denied, 287 U. S. 613, in which it was held that the receipt of its own stock by the taxpayer corporation constituted income, the Treasury Regulations to the contrary notwithstanding. In that case the taxpayer sued another corporation for infringement of a patent; and the parties entered into a settlement under which the other corporation transferred to the taxpayer about 1,000 shares of taxpayer's stock having a value of about $433,000. The question involved was whether the value of the stock received by the taxpayer was taxable income. The case arose under the Revenue Act of 1924 and the applicable Treasury Regulations, which provided in part that "a corporation realizes no gain or loss from the purchase or sale of its own stock." In that case the court said (p. 636):

> Whether the acquisition or sale by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction involved. *Walville Lumber Co.* v. *Com. of Internal Revenue* (C. C. A.) 35 F. (2d) 445; *Spear & Co.* v. *Heiner* (D. C.) 54 F. (2d) 134. If it was in fact a capital transaction, i. e., if the shares were acquired or parted with in connection with a read-

justment of the capital structure of the corporation, the Board rule applies. *Doyle* v. *Mitchell Bros. Co.*, 247 U. S. 179, 184; *Eisner* v. *Macomber*, 252 U. S. 189. But where the transaction is not of that character, and a corporation has legally dealt in its own stock as it might in the shares of another corporation, and in so doing has made a gain or suffered a loss, we perceive no sufficient reason why the gain or loss should not be taken into account in computing the taxable income. * * *

The transaction involved in this case was equivalent to the payment of the debt in cash and the investment of the proceeds by the corporation in its own stock. If that had been done clearly the cash received would have been taxable income. The transaction was not changed in its essential character by the fact that, as the debtor happened also to own the stock, the money payment and the purchase of stock were bypassed, and the stock was directly transferred in payment of the debt. The stock was the medium in which the debt was paid.

Again the decision of the Board was reversed.

The *Woods Mach. Co.* case in turn was followed by a decision of the Third Circuit in *Commissioner* v. *Boca Ceiga Development Co.*, 66 F. (2d) 1004 (1933), in which the taxpayer sold a tract of land to one of its stockholders for a gross consideration of $504,000 and received from the purchaser 480 shares of its capital stock, valued at $48,000, as the initial payment. The question involved was

whether the taxpayer realized any taxable gain on the initial payment made to it with its own stock. The Board of Tax Appeals had held that a corporation realizes neither gain nor loss from the purchase of its own stock, and decided the case in favor of the taxpayer. The Circuit Court of Appeals decided in effect that a corporation's own stock was property under the circumstances of that case, and reversed the decision of the Board of Tax Appeals upon the authority of the *Walville Lumber Co.* case.

A similar result was reached by the Circuit Court of Appeals for the Fifth Circuit in *Dorsey Co.* v. *Commissioner,* 76 F. (2d) 339 (C. C. A. 5th, 1935), certorari denied, 296 U. S. 589. In that case the taxpayer, a corporation, sold property and took as the purchase price cash and 1,000 shares of its own stock. The transaction occurred in 1928, prior to the time that Article 66 of Treasury Regulations 77 was amended, but the case was not decided by the Board of Tax Appeals or the Circuit Court of Appeals until after the Treasury Regulation was amended by T. D. 4430 in 1934. Both the Board of Tax Appeals and the Circuit Court of Appeals decided that under the circumstances the value of the stock should be considered as part of the purchase price which the taxpayer received on account of the sale of its property. The court said (p. 340):

> That gain or loss arising in such an exchange of property of the corporation for

> its own stock is realizable, the later and better considered decisions have held, even before the change of the Regulation. *Walville Lumber Co.* v. *Commissioner* (C. C. A.) 35 F. (2d) 445; *Spear & Co.* v. *Heiner* (D. C.) 54 (2d) 134, 135; *Commissioner* v. *Boca Ceiga Development Co.* (C. C. A.) 66 F. (2d) 1004. * * *

And the Circuit Court of Appeals for the Sixth Circuit reached a similar conclusion in *Allyne-Zerk Co.* v. *Commissioner,* 83 F. (2d) 525 (C. C. A. 6th) (1936), where the stock received by the corporation was cancelled. In answer to the argument that the stock acquired by the corporation did not constitute an asset in its hands, and that the benefit accrued to the stockholders, not to the corporation, the court said (p. 526):

> It is true that the value of the remaining shares was substantially enhanced by the cancellation of the certificates surrendered, and in this sense the remaining shareholders were benefited. However, the petitioner received the stock as a part of the consideration for the sale of the assets. Hence the transaction falls within the exact terms of section 202 (c) of the Revenue Act of 1924, c. 234, 43 Stat. 253, 255, "The amount realized from the sale or other disposition of property shall be the sum of any money received plus the fair market value of the property (other than money) received." * * *

It avails nothing to label the gain in question an accretion to capital. We have already pointed out

the distinction between this gain and the proceeds on the creation of capital stock. The concept of income received is not to be restricted simply by pointing to an increase of capital. An attempt of this sort was made early in the history of the income tax Acts, and was rejected by this Court. It was strenuously urged that the conversion of capital assets could not give rise to income, but only to a substitution or "increase of capital", not taxable under the Sixteenth Amendment. This view appeared at first to prevail (*Lynch* v. *Turrish,* 247 U. S. 221, 230), but was later repudiated (*Merchants Loan & Trust Co.* v. *Smietanka,* 255 U. S. 509), the Court emphasizing the broad range of both the statutory and the constitutional concepts of income. In a real sense the conversion of capital assets does produce an accretion to capital. But, as was decided, that fact is not inconsistent with recognition of the realized enrichment as income. Again, in *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, it was argued that bond premium is not income because it is part of the capital loaned to the debtor. Doubtless, this Court said, the premium is "acquired capital" (p. 559). "But if this be admitted", the Court continued, "the concession does not answer the question whether a premium paid prior to 1913 is taxable." (*Ibid.*)

What has just been said indicates that accounting practice or theory is not a safe guide to measure the extent of the concept of income in the revenue Acts. The court below laid great stress on the con-

troversy among accountants as to the ideal method of treating gains from dealings in a corporation's own shares. Even if accounting practice in this regard were more settled than it is, and failed to treat such gains as income, the statutory definition of income would not have to be restricted accordingly. As this Court has pointed out, "Taxability has frequently been determined without reference to factors which the accountant, economist or business man might deem relevant to the computation of net gain." *Helvering* v. *Midland Ins. Co.*, 300 U. S. 216, 225, note 9, citing *Brushaber* v. *Union Pacific R. Co.*, 240 U. S. 1; *Tyee Realty Co.* v. *Anderson*, 240 U. S. 115; *Weiss* v. *Wiener*, 279 U. S. 333; *Helvering* v. *Independent Life Ins. Co.*, 292 U. S. 371. Even rules of accounting which are enforced upon the taxpayer by another agency of the Government do not control the determination of tax liability. This Court said, in *Old Colony R. Co.* v. *Commissioner*, 284 U. S. 552, 562: "Moreover, the rules of accounting enforced upon a carrier by the Interstate Commerce Commission are not binding upon the Commissioner, nor may he resort to the rules of that body, made for other purposes, for the determination of tax liability under the revenue acts."

In the present case there are special additional reasons why accounting practice and theory cannot serve to take respondent's gain out of the category of income. The first reason is that respondent's own accounting practice, like that of many other

corporations,[1] treated the treasury shares as assets ("investments in non-competitive companies") and the gain on sale as income. Respondent's tax returns, in reconciling its book income with its taxable income, denominated the gain "non-taxable income." (R. 17–18.) The second and more fundamental reason is that insofar as accounting authority recommends a different treatment,—as for example a reduction in the outstanding shares shown, on acquisition of the stock, and an addition to capital surplus on sale at a profit—the recommendation is founded on practical considerations intended to lessen the possibility of dangers and abuses in a corporation's dealings in its own shares. Because of the emphasis placed by the court below on the conflicting views of accountants, it seems desirable to explain more fully the level of discussion upon which those views proceed.

The accountant's function, of course, is to disclose the financial condition of the corporation in a manner most instructive to the management and to creditors and investors. In taking account of treasury shares, conservative accounting practice might well be guided by the possibilities of injury and deception involved. From the standpoint of creditors and investors, as well as of sound man-

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[1] In Holt and Morris, *Some Aspects of Reacquired Treasury Stock, 1931–1933*, 12 Harvard Business Review 505, 508, it is stated that out of 80 corporations investigated 25 carried treasury stock as an asset.

agement,[2] the acquisition of shares by a corporation may perhaps be viewed as a contraction of its assets; and gain derived from the sale of the shares may be viewed as a profit extraneous to the earning capacity of the business. Treasury shares have on occasion been used for the purpose of circumventing the provisions of law requiring newly-issued stock to be fully paid, for the purpose of vesting voting control in a minority of stockholders, for the purpose of granting preferential treatment to selected stockholders, and for other objectionable purposes.[3] Because of the possibilities of injury and deception, the purchase by a corporation of its own shares without their retirement is in general forbidden by English and Continental law.[4] Here,

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[2] The importance of the accounting treatment of treasury stock from the standpoint of the dividend policy of the corporation is emphasized in R. E. Payne, *Treasury or Reacquired Stock*, Certified Public Accountant, Feb. 1936, p. 98.

[3] See 1 Machen, *Modern Law of Corporations*, sec. 626; 1 Morawetz, *Private Corporations* (2d ed.) sec. 112; Levy, *Purchase By a Corporation of Its Own Stock*, 15 Minnesota Law Review 1. The Committee on Stock List of the New York Stock Exchange declared, in December 1933: "The Committee on Stock List has long urged corporations not to trade in their own shares. The Committee can see no justification whatsoever for a corporation using its assets to influence the market quotation of its own shares. Until recently, the practice of corporations either trading in their own stock or reacquiring substantial amounts of their outstanding stock was unusual." (N. Y. Times, Dec. 28, 1933, pp. 29, 31; quoted in Journal of Accountancy, July 1938, p. 19).

[4] See Nussbaum, *Acquisition by a Corporation of Its Own Shares*, 35 Columbia Law Review 971, 976. The leading English case is *Trevor* v. *Whitworth*, 12 A. C. 409; see also Companies Act of 1929, 19 & 20 Geo. 5, c. 23, sec. 45.

although national banks are prohibited from purchasing their own shares (12 U. S. C., Sec. 83), the laws of the States with some exceptions permit corporations to engage in the practice. That being so, it is doubtless desirable that conservative accounting practice be employed as a restraint on the corporation and as a helpful guide to creditors and investors.[5]

The resulting divergence between recommended accounting practice on the one hand and the ordinary or statutory concept of income on the other, with specific reference to sales of treasury stock, is strikingly disclosed in a recent article by the Chairman of the Committee on Accounting Procedure of the American Institute on Accountants. In supporting the recommendation that profits from the sale of treasury stock not be treated as income in the corporate accounts, the author states:[6]

> The problem of the accountant is primarily to present accounts in the manner in

[5] In discussing possible methods of treating treasury shares on the corporate books, Finney, *Principles of Accounting*, (1937), Vol. 1, p. 88, states:

"The proper treatment of premiums and discounts will depend upon the answer to the following questions: (1) Is there any desire to distinguish between operating profits (by crediting them to surplus) and extraneous profits on treasury stock transactions (by crediting them to capital surplus or to some other special account)? (2) Does the law of the state of incorporation permit the payment of dividend from discounts on the purchase of treasury stock before such discounts are realized by the resale of the stock at a price in excess of cost?"

[6] George O. May, *Recent Opinions on Dealings in Treasury Stock*, Journal of Accountancy, July 1938, pp. 17, 20.

> which they will be most helpful for the legitimate purposes for which they are designed. * * * I believe that what we now call the income account should not include either profits or losses on dealings in treasury stock, or even profit from the redemption of bonds at a discount, or profits or losses on the sale of capital assets, except in so far as the last mentioned may represent a redetermination of provisions for depreciation or depletion.

It will be observed that along with profits from dealings in treasury stock there are here grouped for accounting purposes two classes of profit that are beyond question income under the Revenue Acts: profit from the redemption of bonds at a discount (*United States* v. *Kirby Lumber Co.*, 284 U. S. 1) and profits on the sale of capital assets (*Merchants Loan & Trust Co.* v. *Smietanka*, 255 U. S. 509). It has been suggested, with a good deal of force, that with respect both to profits from the sale of capital assets and profits from the sale of treasury stock, recognition of the essential character of the profits as income can be reconciled with desirable accounting practice by crediting the profit to earned surplus and immediately transferring it to capital surplus.[7] However this may be, the passage quoted above should be enough to demonstrate that if the profits involved in the present case are not to be regarded as income under the Revenue Acts, something more is needed than the recom-

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[7] R. H. Montgomery, *Dealings in Treasury Stock*, Journal of Accountancy, June 1938, p. 466.

mendation of a school of accountants that the profits ought to be placed in a capital account.

It is submitted, therefore, that the gain realized by respondent from dealing in its own shares was income within the constitutional and statutory meaning of the term. It remains to consider the bearing of the regulations on the question.

II

REGULATIONS 74, AS AMENDED, IN TERMS TREATS THE GAIN HERE INVOLVED AS INCOME, AND THERE IS NO REASON TO DENY APPLICATION TO THOSE REGULATIONS

As amended by T. D. 4430, approved May 2, 1934, *infra*, p. 52, Article 66 of Regulations 75, approved February 15, 1929, reads as follows:

> Articles 543 of Regulations 65, approved October 6, 1924, and Regulations 69, approved August 28, 1926, and articles 66 of Regulations 74, approved February 15, 1929, and Regulations 77, approved February 10, 1933, are hereby amended to read as follows:
>
> *Acquisition or disposition by a corporation of its own capital stock.*—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives

rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

But where a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of applicable statutes.

* * * * *

It is not open to question that this regulation applies in terms to facts such as those here involved, and in terms governs pending proceedings involving the year here in question. The Board and the court below so understood, and respondent presumably does not take issue on this point. And if our argument in Point I, *supra,* is sound, the regulation in its amended form interprets correctly the constitutional and statutory definition of income. The remaining question is whether the intention that the regulation should apply is to be given effect. We maintain that it should, for the reasons (1) that Congress has given express au-

thority in the Revenue Acts to make amended regulations thus effective, and (2) that there is no basis here for implying a Congressional intent to the contrary, particularly in view of the nature of the regulation involved.

The duty is vested in the Commissioner, with the approval of the Secretary of the Treasury, to "prescribe and publish all needful rules and regulations for the enforcement of" the income tax law. See, *e. g.,* Section 62, Revenue Act of 1928, *infra,* p. 51. The power to amend regulations is, of course, contained in the general grant; and at least as far back as 1921 Congress made it plain that amended regulations should be applied, in general, without limiting their application to future transactions. This is quite plainly brought out in Section 1314 of the Act of 1921, *infra,* p. 52, entitled "Retroactive Regulations", which provided that the Commissioner might in his discretion, with the approval of the Secretary, apply an amended regulation "without retroactive effect", but only where the amendment was "not immediately occasioned or required by a decision of a court". General application of an amended regulation was thus to be the rule; merely prospective application was to be the exception. In the 1926 Act the same provision was repeated. Sec. 1108 (a). It was not until the Act of 1928, Sec. 605, *infra,* p. 51, that the discretion of the Commissioner was enlarged to permit him, with the approval of the Secretary, to apply an amended regulation without retroactive effect irrespective of the occasion for the amendment.

In insisting that effect be denied to the power thus expressly given to the Commissioner, the respondent points to the earlier Regulations and relies on the doctrine that reenactment of the statutory definition of net income while those Regulations were in force is persuasive evidence of Congressional approval of the Regulations. It is true that the earlier Regulations from 1918 to 1934 provided that "A corporation realizes no gain or loss from the purchase or sale of its own stock". See page 52, *infra.* It may be observed in passing that a still earlier Regulation, applicable to the Act of 1916, contained a provision like that in the present Regulations: "If such stock [Treasury stock] is resold at a price in excess of its cost upon repossession, such excess shall be returned as income for the year in which resold." Regulations 33 (Revised), Article 98, *infra,* p. 54.

More important, however, is the fact that the Regulations in their *present amended form* may also be deemed to have secured Congressional approval by virtue of the reenactment of the statutory provision in two succeeding Revenue Acts.[8] Reenactments after the taxable year are as significant as a reenactment by the statute governing the taxable year. E. g., *Brewster* v. *Gage,* 280 U. S. 327, 337; *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, 307; *Reinecke* v. *Smith,* 289 U. S. 172, 175. And the doctrine of reenactment applies to Regulations in their amended form as well as to

[8] Revenue Acts of 1936 and 1938.

Regulations in an earlier form. *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 307; *Morrissey* v. *Commissioner,* 296 U. S. 344, 355. If the doctrine of reenactment is to be controlling, it is necessary to make an artificial choice between implied approval of the earlier Regulations and implied approval of the amended Regulations. In this situation it is submitted that the choice should be determined by the express authority conferred by Congress on the Commissioner with respect to the amendment of Regulations.

More fundamentally, however, we believe that the argument of respondent based on the doctrine of reenactment rests on a misconception of that doctrine. We believe that the decisions announcing and applying the rule of reenactment were not intended to mean that the Commissioner is powerless to reexamine and reformulate a Regulation of the character here involved, and that, as the Court in the *Squibb* case declared, an unsound Regulation interpreting a general statutory provision coextensive with the constitutional grant of power can be dislodged, if unsound, only by Congress. The number of income tax cases in which this Court has applied the rule of reenactment is impressive.[9] But they do not touch the problem here involved.

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[9] *Brewster* v. *Gage,* 280 U. S. 327, 337; *Poe* v. *Seaborn,* 282 U. S. 101, 116; *Burnet* v. *Thompson Oil & Gas Co.,* 283 U. S. 301, 307; *McCaughn* v. *Hershey Chocolate Co.,* 283 U. S. 488, 492; *United States* v. *Kirby Lumber Co.,* 284 U. S. 1, 3; *Old Colony R. Co.* v. *Commissioner,* 284 U. S. 552, 557; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 302, 307; *Massachusetts Mut. Life Ins. Co.* v. *United States,* 288 U. S. 269,

In most of the cases the Court sustained the position of the Government that an administrative construction should not be judicially disturbed, except for cogent reasons, where Congress has reenacted the statute without change. In a few of the cases the Court applied the rule of reenactment despite the Government's contention that for special reasons it was inapplicable.[10] But in none of the cases in which this Court applied the rule of reenactment did the Court do so to prevent the application of a subsequently amended Regulation. It is therefore respondent's position which is novel.

That respondent's is the novel position is made clear when it is recalled that this Court has in fact given effect to amended Regulations despite the reenactment of the statutory provisions while former Regulations were in force: *Morrissey* v. *Commissioner,* 296 U. S. 344; *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299. The *Morrissey* case involved the meaning of the term "association." In determin-

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273; *United States* v, *Dakota-Montana Oil Co.*, 288 U. S. 459, 466; *Reinecke* v. *Smith*, 289 U. S. 172, 175; *Helvering* v. *Bliss*, 293 U. S. 144, 151; *Zellerbach Co.* v. *Helvering*, 293 U. S. 172, 178, 180; *Old Mission Co.* v. *Helvering*, 293 U. S. 289, 293; *Hartley* v. *Commissioner*, 295 U. S. 216, 220; *McFeely* v. *Commissioner*, 296 U. S. 102, 108; *Morrissey* v. *Commissioner*, 296 U. S. 344, 355; *United States* v. *Safety Car Heating Co.*, 297 U. S. 88, 95; *Lang* v. *Commissioner*, 304 U. S. 264, 270; *Helvering* v. *Winmill*, No. 11, present Term decided November 7, 1938. See, also, *Heiner* v. *Colonial Trust Co.*, 275 U. S. 232.

[10] In *Poe* v. *Seaborn* and *McFeely* v. *Commissioner*, *supra*, note 8, the Government urged that the statute had been amended, and, in *Helvering* v. *Bliss*, *supra*, note 8, that the administrative practice did not have the force of Regulations.

ing that meaning there was promulgated under the 1918 and 1921 Acts, following the decision in *Crocker* v. *Malley,* 249 U. S. 223, a Regulation declaring that if the beneficiaries of a business trust have a voice in the business it is an association, Regulations 45, 62, Article 1504. After the decision in *Hecht* v. *Malley,* 265 U. S. 144, the Treasury issued Regulations 65, Article 1504, as amended by T. D. 3748, to the effect that even in the absence of control by the beneficiaries, if trustees of an operating trust are associated like corporate directors for the purpose of a business enterprise, the trust constitutes an association. In holding that the subsequent Regulations were to be applied despite legislative reenactment while the earlier Regulations were in force, this Court stressed the necessary and appropriate range of administrative power to reexamine and reformulate its construction (296 U. S. at 354–355):

> As the statute merely provided that the term "corporation" should include "associations," without further definition, the Treasury Department was authorized to supply rules for the enforcement of the Act within the permissible bounds of administrative construction. Nor can this authority be deemed to be so restricted that the regulations, once issued, could not later be clarified or enlarged so as to meet administrative exigencies or conform to judicial decision. Compare *Murphy Oil Co.* v. *Burnet,* 287 U. S. 299, 303–307. We find no ground

for the contention that by the enactment of the Revenue Act of 1924 the Department was limited to its previous regulations as to associations.

In the *Morrissey* case, as this Court pointed out (296 U. S. at 356), taxpayers who had filed returns as trusts for taxable years prior to 1925 under previous Regulations and rulings were relieved from the application of the amended Regulations by specific Congressional provision contained in Section 704 of the Revenue Act of 1928. In the *Murphy Oil Co.* case, cited in the *Morrissey* opinion, no such Congressional exemption was given, and the Regulations as amended in 1926 were held to govern the allowance of depletion in respect of royalties received in 1919 and 1920, governed by the Revenue Act of 1918. The validity of the original Regulations was not discussed by the Court. It is apparent that in the *Murphy Oil Co.* case the application of amended Regulations was made to transactions antedating the amendments by a greater period than that existing in the case at bar.

As the Regulations here involved are interpretive of a general statutory provision intended to be declaratory of constitutional power, the authority to reexamine and reformulate the Regulations is exercised with particular appropriateness; and, by the same token, the doctrine of reenactment loses much of its force. Here the general language contained in Section 22 of the Act is, as has been shown above, an attempt by Congress to restate a grant of power found in the Constitution. The Commis-

sioner has sought merely to explain further the constitutional and statutory grant. In so doing he performs essentially the function of a judicial agency; and it is a characteristic of such a function that its exercise ordinarily governs transactions already consummated which are the subject of pending controversy. Where the interpretive function entails a modification or overruling of prior pronouncements, the effect is enhanced. In those instances, for example, where this Court has modified or overruled precedents involving constitutional questions under the tax laws, the later view, deemed to be the sounder one, governs the pending controversy and prior transactions which are still open to question, in the absence of administrative or Congressional exemption. Compare *Gerhardt* v. *Commissioner,* 304 U. S. 405, rehearing denied, October 10, 1938; *Helvering* v. *Mountain Producers Corp.,* 303 U. S. 376. The analogy to judicial decision has been invoked by this Court to permit a retroactive correction of a legislative regulation—one which prescribes a rule implementing the statute. *Manhattan Co.* v. *Commissioner,* 297 U. S. 129, 135. Cf. *Titworth* v. *Commissioner,* 73 F. (2d) 385 (C. C. A. 3d). The analogy is even more persuasive in the case of an interpretive regulation, and most persuasive in the case of a regulation seeking to interpret constitutional power. No good reason is apparent why the Commissioner may not take the initiative in reviewing prior interpretations instead of calling on the courts to make the appropriate change without a formal change by

the Commissioner. The intervening reenactment of the general provision in Section 22 cannot be taken, it is submitted, as Congressional approval of what would otherwise be regarded as untenable constitutional doctrine. This is so because, as was said by this Court in *Helvering* v. *Powers*, 293 U. S. 214, 224, concerning regulations intended to interpret the constitutional doctrine of intergovernmental immunity:

> * * * the Treasury Department could not by its regulation either limit the provisions of the statute or define the boundaries of their constitutional application.

See also *Helvering* v. *Gowran*, 302 U. S. 238, 244 note; *Koshland* v. *Helvering*, 298 U. S. 441.

In summary, the Commissioner was expressly vested by Congress with power to amend the Regulations; and the intervening reenactment of the general definition of gross income in the Revenue Acts cannot be deemed an implied revocation of the power, particularly in view of the reenactment of the statutory definition subsequent to the amendment, the interpretative character of the Regulation, and the fact that it is addressed to a matter of the constitutional power of Congress itself.

Respondent's attack on the amended Regulation is thus necessarily a challenge of the propriety of the exercise by the Commissioner of discretion vested in him. It can be agreed that long-standing Regulations ought not lightly to be disturbed, as a

matter of administrative practice, except for substantial cause. But if it were true that undue hardship resulted from the exercise of the amending power, the remedy lies with Congress, as in the case of remedial legislation following upon judicial modification of a prior doctrine. Compare *Morrissey* v. *Commissioner,* 296 U. S. 344, 356. The Commissioner in the first instance, and then Congress, can take into account all material considerations in determining whether disproportionate hardship will result, as for example whether the early Regulations were themselves not wholly clear and whether the transactions affected were of the kind entered into with a substantial view to the question of tax liability.

In the present case, it should be emphasized, there were important considerations making the amendment reasonable and appropriate. The earlier Regulations did not deal specifically with the trafficking by a corporation in its own shares; their language was general, but the context indicated that dealings in a corporation's own stock as in the stock of another were not covered with particularity. This was recognized in *Dorsey Co.* v. *Commissioner,* 76 F. (2d) 339, 340, per Sibley, J.:

> The point of law dealt with by the Board is whether the transaction was controlled by the last sentence of Regulation 74, Art. 66: "A corporation realizes no gain or loss from the purchase or sale of its own stock."

A reading of the whole Regulation, which had existed at least since 1918, shows that it referred mainly to the original sale of the capital stock and to stock turned back by stockholders to be resold to raise more capital. It was amended in 1934 by T. D. 4430 to distinguish clearly between original capital transactions and ordinary commercial dealings in its own stock as in that of another corporation.

Furthermore, as has been explained above (pages 27 to 30), the amendment was occasioned by a series of decisions of Circuit Courts of Appeals which indicated that in their then form the language of the Regulations was too broad. The court below adverted to the fact that it was the decision in the *S. A. Woods Co.* case, *supra,* that led to the promulgation of the amended Regulation and furnished the model for its language (R. 76). Moreover, the result of the amendment, as the facts of the present case show, is not simply to tax gains, but to allow losses as well, on a corporation's dealing in its shares.

In these circumstances, we submit, the Commissioner properly discharged his duty in amending the Regulations, leaving for the courts the question whether in its revised form the Regulation is a sound interpretation of the concept of income, and to Congress the question whether any class of taxpayers is entitled to exemption from its operation.

CONCLUSION

For the foregoing reasons, it is submitted that the judgment of the court below should be reversed and that of the Board of Tax Appeals affirmed.

Respectfully submitted,

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Attorney.

DECEMBER 1938.

APPENDIX

STATUTE AND OTHER AUTHORITIES INVOLVED

Revenue Act of 1928, c. 852, 45 Stat. 791:

SEC. 22. GROSS INCOME.

(a) *General definition.*—"Gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service, of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever.

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SEC. 62. RULES AND REGULATIONS.

The Commissioner, with the approval of the Secretary, shall prescribe and publish all needful rules and regulations for the enforcement of this title.

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SEC. 605. RETROACTIVE REGULATIONS.

Section 1108 (a) of the Revenue Act of 1926 is amended to read as follows:

"SEC. 1108. (a) In case a regulation or Treasury decision relating to the internal-revenue laws is amended by a subsequent regulation or Treasury decision, made by the Secretary or by the Commissioner with the approval of the Secretary, such subsequent regulation or Treasury decision may, with the approval of the Secretary, be applied without retroactive effect." (U. S. C., Title 26, Sec. 1691.)

Revenue Act of 1921, Retroactive Regulations:

Sec. 1314. That in case a regulation or Treasury decision relating to the internal-revenue laws made by the Commissioner or the Secretary, or by the Commissioner with the approval of the Secretary, is reversed by a subsequent regulation or Treasury decision, and such reversal is not immediately occasioned or required by a decision of a court of competent jurisdiction, such subsequent regulation or Treasury decision may, in the discretion of the Commissioner, with the approval of the Secretary, be applied without retroactive effect.

Treasury Regulations 74, relating to the Revenue Act of 1928:

Art. 66. *Sale by corporation of its capital stock.*—The proceeds from the original sale by a corporation of its shares of capital stock, whether such proceeds are in excess of or less than the par value of the stock issued, constitute the capital of the company. If the stock is sold at a premium, the premium is not income. Likewise, if the stock is sold at a discount, the amount of the discount is not a loss deductible from gross income. If, for the purpose of enabling a corporation to secure working capital or for any other purpose, the shareholders donate or return to the corporation to be resold by it certain shares of stock of the company previously issued to them, or if the corporation purchases any of its stock and holds it as treasury stock, the sale of such stock will be considered a capital transaction and the proceeds of such sale will be treated as capital and will not constitute income of the corporation. A corporation realizes no gain or loss from the purchase or sale of its own stock. (See article 176.)

Treasury Decision 4430, approved May 2, 1934, XIII-1 Cumulative Bulletin 36:

ARTICLE 66: Sale by corporation of its capital stock. XIII-20-6792 T. D. 4430

(Also Section 23 (i), Article 176.)

INCOME TAX.

Acquisition or disposition by a corporation of its own capital stock.

Articles 543 and 563, Regulations 65 and 69, and articles 66 and 176, Regulations 74 and 77, amended.

TREASURY DEPARTMENT,
OFFICE OF COMMISSIONER
OF INTERNAL REVENUE,
Washington, D. C.

To Collectors of Internal Revenue and Others Concerned:

Articles 543 of Regulations 65, approved October 6, 1924, and Regulations 69, approved August 28, 1926, and articles 66 of Regulations 74, approved February 15, 1929, and Regulations 77, approved February 10, 1933, are hereby amended to read as follows:

Acquisition or disposition by a corporation of its own capital stock.—Whether the acquisition or disposition by a corporation of shares of its own capital stock gives rise to taxable gain or deductible loss depends upon the real nature of the transaction, which is to be ascertained from all its facts and circumstances. The receipt by a corporation of the subscription price of shares of its capital stock upon their original issuance gives rise to neither taxable gain nor deductible loss, whether the subscription or issue price be in excess of, or less than, the par or stated value of such stock.

But where a corporation deals in its own shares as it might in the shares of another corporation, the resulting gain or loss is to be computed in the same manner as though the corporation were dealing in the shares of another. So also if the corporation receives its own stock as consideration upon the sale of property by it, or in satisfaction of indebtedness to it, the gain or loss resulting is to be computed in the same manner as though the payment had been made in any other property. Any gain derived from such transactions is subject to tax, and any loss sustained is allowable as a deduction where permitted by the provisions of applicable statutes.

Articles 563 of Regulations 65, approved October 6, 1924, and Regulations 69, approved August 28, 1926, are hereby amended by striking out the first and second sentences thereof, by substituting the words "a corporation" in place of the second word in the third sentences of those articles, and by adding the following sentence to those articles:

As to the acquisition or disposition by a corporation of its own capital stock, see article 543.

Article 176 of Regulations 74, approved February 15, 1929, is hereby amended by omitting the first and second sentences thereof, by substituting the words "a corporation" in place of the second word in the third sentence of this article, and by adding the following sentence to this article:

As to the acquisition or disposition by a corporation of its own capital stock, see article 66.

Article 176 of Regulations 77, approved February 10, 1933, is hereby amended by omitting the first and second sentences thereof, and by adding the following sentence to this article:

As to the acquisition or disposition by a corporation of its own capital stock, see article 66.

GUY T. HELVERING,
Commissioner of Internal Revenue.

Approved May 2, 1934.

H. MORGENTHAU, Jr.,
Secretary of the Treasury.

Treasury Regulations 33 (Revised), relating to the Revenue Act of 1916:

ART. 98. *Treasury stock—When taxable.*—Treasury stock, wherever and whenever that term is used in connection with the accounts of the corporation or for income-tax purposes, will be held to mean stock which had been previously issued by the corporation and which had been repossessed by it through purchase or otherwise and then carried on its books as an asset. If such stock is resold at a price in excess of its cost upon repossession, such excess shall be returned as income for the year in which resold. Unissued stock, which had been retained by the corporation for the purpose of future sale, will not, for the purpose of the income tax, be considered "Treasury stock," and when sold no part of the proceeds of such sale will be considered taxable income. Nor will there be any deductible loss if such stock is sold at a price less than par.

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